

Preparing for the road ahead

Broadridge's Demi Derem says deep domain knowledge, scale, and financial stability, along with the highest digital data security and complete market coverage are all crucial to staying ahead of regulations such as SRD II

On 4 September 2020, the European Union's (EU) revised Shareholder Rights Directive (SRD II) came into effect. The purpose behind the updated directive is to enable greater transparency between issuers and their shareholders, and to encourage investors to become more involved in shareholder voting activities.

The key changes behind SRD II

The introduction of SRD II has made the provision of voting and election services mandatory for all intermediaries that handle European shares, including both retail and institutional-focused banks, brokers and wealth managers. The changes to the identification and the transmission of information can be categorised into three key themes:

The identification of shareholders: Issuers are now entitled to obtain a list of their shareholders whenever they like, and as often as they like. When asked for this data, intermediaries must provide a response to the issuer, containing the full list of required shareholders, by the end of the next business day.

The EU has also outlined timings for the forwarding of requests to downstream intermediary clients, which must be completed by the end of business day for requests received before 4pm local time, and by 10am the following business day for requests received after 4pm local time.

Finally, when forwarding the issuer request downstream, the first intermediary in the chain must always authenticate the issuer agent's role, and the response channel through which disclosures should be sent.

General meeting information and shareholder voting: This new on-demand access to data also translates across to corporate action notifications and shareholder meeting announcements. Voting receipts and confirmation that votes have been cast and counted — which must be sent directly to investors and their intermediaries — are two new processes that have been introduced in SRD II. Intermediaries must also now be able to receive, process and send electronic machine-readable messages.

To help firms navigate the new regulation, the Securities Market Practice Group (SMPG) recommended the ISO 20022 message format, as it is a clearly defined standard that complies with all aspects of the implementing regulation and is designed with all specific aspects of proxy voting in mind.

The impact on financial corporate actions: In order to be compliant with SRD II, firms must include the beneficial owner details in their election message, along with legal entity identifiers (LEIs). The frequency of notifications has also increased to meet the requirements for end-of-day delivery.

Challenges on the road to implementation

While SRD II may be a European-focused regulation, its implementation in September 2020 has had a global impact. This is because it is applicable to any intermediary that trades or holds European equities, irrespective of where the intermediary is based. Preparing for this regulation — which for many firms has created an entirely new responsibility — was challenging and complexity around execution has been compounded by the global pandemic.

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Demi Derem

General manager, bank broker-dealer
investor communication solutions
Broadridge

Firms have had to balance becoming compliant with SRD II alongside having to adapt to a whole new way of working. Many have had less time to dedicate to dealing with corporate actions processing, even though there have been many general meeting cancellations due to social distancing measures, staff shortages and increased operational risk in the work-from-home environment.

Despite this, the industry has largely done a remarkable job to embrace SRD II regulation, and overcome the following range of challenges that became apparent during implementation:

Shareholder identification: For nearly all of the European markets, the identification of shareholders was a relatively new process. For the eight countries that already had some form of shareholder identification, they still had to significantly adapt their current practices to adhere to the strict requirements of SRD II, so that they could fulfil all of their cross-border obligations.

Different stages of adoption: When SRD II came into force in September 2020, European countries were at varying stages of transposition. For example, Austria, Estonia (from holders of nominee accounts), Italy, the Netherlands and Slovakia had introduced national share ownership thresholds of 0.5 per cent above which shareholders could be identified.

Some countries had not yet fully transposed SRD II into national law. As of January 2021, Norway and Iceland are still awaiting the European Economic Area agreement to be updated before they transpose the directive. The different stages of implementation across the EU have proved to be significantly challenging for businesses that operate within and with those countries in terms of meeting compliance obligations.

For intermediaries operating in a cross-border context, the difference in time zones has also proven difficult to meet the daily response deadlines for shareholder identification requests, especially for third country firms that are in significantly different time zones to the EU. Managing the record dates is another aspect of the process that requires close attention, and extra

care needs to be taken for requests sent before the record date (because intermediaries must monitor transactions on the underlying security and ensure that they are informed of the request up until the record date has passed).

Market structure challenges: This disparity in SRD II adoption across Europe had a subsequent knock-on effect to central securities depository (CSD) adoption of the required ISO 20022 messaging for issuer communications.

Different processes for reporting and penalties: Reporting non-compliance has also been tricky. Depending on the circumstances, intermediaries may be obliged to report to all 27 of the EU member state national competent authorities and those in the EEA.

Financial penalties for failing to comply with SRD II also vary considerably from jurisdiction to jurisdiction. On one hand, there are some regulators that are not planning to introduce any fines at all, yet on the other hand, there are regulators, such as those operating in Austria and France, who are organising heavy penalties for non-compliance.

Message mapping work: The SMPG worked hard to establish mapping between the existing and the revised ISO 20022 messages for meeting notifications and shareholder voting.

By replacing the MX messages and updating the eight existing ISO 20022 proxy voting messages, the number of messages firms are required to send will be reduced.

Triparty collateral arrangement: The application of voting rights to European securities held within a triparty collateral arrangement has proven to be more difficult than expected. This is due to the challenges in managing collateral in 2020's stressed market environment.

In order for the proxy voting rights to be exercised, EU securities must be called back as per the triparty agent agreement and must be substituted with eligible replacement collateral, which has been scarce due to ongoing market volatility.

It is important to not be left behind

For those that are still working on fulfilling their compliance obligations, there are three key areas they should concentrate their efforts on:

- **Carry out shareholder identification best practice:** Firms should understand that they need to collect and maintain shareholder data regardless of nationally-set thresholds for disclosure. This will ensure that should shareholdings change during the request process, intermediaries will still be able to meet the issuer requests accordingly.
- **Adopt ISO 20022:** Existing messages such as ISO 15022, and even the older proxy voting ISO 20022, are not compliant with SRD II. The new ISO 20022 format has been updated with 32 new elements to ensure that it fulfils all requirements of SRD II. To avoid financial penalties, firms should adopt ISO 20022 messaging and market practices to help meet the new directive with confidence.
- **Keep in mind SRD II's review:** The European Commission is set to review SRD II's effectiveness and to revise the directive further in either 2022 if current plans remain in effect, or in 2023. It is likely that proactive national authorities are going to take a much stricter approach when it comes to non-compliance in the lead-up to the review.

While SRD II is still a relatively new directive, it is a key focus on the Capital Markets Union agenda and so it is expected to remain a high priority compliance programme over the next two years.

We also predict that investor and regulator ESG themes and concerns will also continue to be drivers of further change. It is important that firms are fully prepared in order to avoid both the reputational and financial consequences for failing to comply.

In order to be prepared, we recommend that firms allocate sufficient budget and resources in advance.

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For those looking for outside assistance, they should turn to companies that can offer them deep domain knowledge, scale, and financial stability, along with the highest digital data security and complete market coverage.

All of these are crucial to stay ahead of regulations such as SRD II and to meet all EU market and global compliance obligations with confidence.